

**Franchise Tax Board****ANALYSIS OF ORIGINAL BILL**

Author: Ashburn Analyst: Victoria Favorito Bill Number: SBX1 23  
Related Bills: See Legislative History Telephone: 845-3825 Introduced Date: October 11, 2007  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Cafeteria Plan Administrative Costs Credit/FTB Report To The Legislature On the Utilization Of The Tax Credit

**SUMMARY**

This bill would allow a credit against corporation and personal income tax (PIT) for administrative costs associated with establishing or administering a "cafeteria plan."

**PURPOSE OF THE BILL**

According to the author's staff, the purpose of this bill is to create an economic incentive for employers to establish cafeteria plans for their employees to purchase health care benefits.

**EFFECTIVE/OPERATIVE DATE**

As a tax levy, this bill would be effective immediately upon enactment and would apply to taxable years beginning on or after January 1, 2007, and before January 1, 2012.

**POSITION**

Pending.

**ANALYSIS****FEDERAL/STATE LAW****Health Care Benefits**

Current federal law allows employers to extend certain benefits, including health care benefits, to employees without requiring inclusion of such benefits in the gross income of employees. For example, employees can exclude from gross income amounts received from an employer, directly or indirectly, as reimbursement for expenses for the medical care of the employee, the employee's spouse, and the employee's dependents.

**Board Position:**

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
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<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

**Department Director****Date**

Selvi Stanislaus

11/28/07

An employee also excludes from gross income the cost—that is, premiums paid—of employer-provided coverage under an accident or health plan.<sup>1</sup> Insurance premiums paid for partners and more-than-2% S corporation shareholders are not excludable. Highly compensated individuals who benefit from an employer's "self-insured" medical reimbursement plan that discriminates in favor of "highly compensated employees," as those terms are defined, must include in income benefits not available to other participants in the plan.<sup>2</sup>

Under Internal Revenue Code (IRC) section 125, current federal law allows employers to offer a choice of benefits—assuming such benefits are otherwise excluded from gross income under a specific provision of the IRC—or cash to employees. A plan under IRC section 125 is also known as a "cafeteria plan." It is a written plan under which employee-participants may choose their own "menu" of benefits consisting of cash and "qualified benefits." No amount is included in the gross income of the employee-participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan. Employer contributions to a cafeteria plan can be made under a salary reduction agreement with the employee-participant if it relates to compensation that hasn't been received by, and does not become currently available to, the participant.

A cafeteria plan can also include "flexible spending accounts" (FSAs) that are funded by employee contributions on a pre-tax salary reduction basis to provide coverage for specified expenses—such as qualified medical expenses or dependent care assistance—that are incurred during the coverage period and may be reimbursed.

IRC section 125 provides special rules with respect to plans that discriminate based on eligibility and benefits in favor of "highly compensated participants" and "key employees."

The practical benefit of cafeteria plans is that employees may make contributions in payment of benefits, such as insurance premiums, on a pre-tax basis. Such contributions reduce the amount of wages that would otherwise be subject to social security and Medicare taxes for both the employee and employer.<sup>3</sup>

Except for FICA withholding, California generally conforms to federal law in this area.

### **Credits Generally**

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

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<sup>1</sup> IRC § 106.

<sup>2</sup> IRC § 105(h).

<sup>3</sup> For federal purposes, under the Federal Insurance Contributions Act (FICA), in addition to withholding for personal income tax, wages are subject to withholding for both social security (also known as OASDI for Old Age, Survivors, and Disability Insurance) and Medicare. For 2007, the social security tax wage base limit is \$97,500. The employee tax rate is 6.2%, for a maximum contribution of \$6,045. The employee tax rate for Medicare is 1.45%. There is no wage base limit for Medicare tax. Employers are required to pay social security and Medicare tax on wages paid in the same amount of the employee contribution.

### THIS BILL

This bill would establish, under both the personal income tax law and the corporation tax law, a credit against franchise or income tax in the amount of 15% of administrative costs incurred by a qualified taxpayer in connection with establishing or administering a cafeteria plan that provides for the payment of health insurance premiums of the taxpayer's employees.

The bill would define the term "qualified taxpayer" as an employer, meaning any individual or entity that is doing business in California that is deriving income from California sources or is subject to the laws of California. The term "employer" also means the State of California and all of its political subdivisions, Regents of the University of California, any other political body or agency of the state, and any person, officer, employee, department, or agency paying wages to employees for services performed within California.

The bill would deny a deduction for any portion of expenses for which the credit is allowed and would not allow this credit for expenses for which any other credit under the personal income tax or corporation tax law was allowed. The bill would also allow any unused credit to be carried over for seven years.

The bill would require FTB to provide a report on the utilization of the credit to the chairs and vice chairs of the Senate and Assembly Health Committees and the Senate and Assembly Revenue and Taxation Committees. The report is required to be submitted on or before January 1, 2011, and must provide information regarding the effectiveness of the credit, including the amount of the credit claimed, an estimate of the number of IRC section 125 cafeteria plans established, and the number of employees affected, and information regarding the types of benefits offered by these plans.

The bill would repeal the credit on December 1, 2012.

### IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these concerns and other concerns that may be identified.

The bill does not define the term "administrative costs." The absence of a definition to clarify this term could lead to disputes with taxpayers and complicate the administration of this credit. It is suggested that the bill be amended to provide a definition for this term.

The bill does not specify whether the amount of cost in the initial year can include both the costs associated with establishing **and** administering the cafeteria plan.

## TECHNICAL CONSIDERATIONS

It is recommended that the definition of the term “employer” be revised. The bill provides for a tax incentive for employers to set up a cafeteria plan. However, the definition of “employer” includes the following non taxpayers and thus would not benefit from this bill: limited liability company, State of California, Regents of the University of California, and freeholders’ charter.

The bill language for the definition of “employer” applies the "making payments of wages to employees for services performed within this state" element of the definition to government entities in the second sentence of the paragraph, but not to the "person, corporation, association or limited liability company" list in the first sentence. The attached amendment would correct this problem.

## **LEGISLATIVE HISTORY**

AB 8 (Nunez, 2007/2008) would have created the California Cooperative Health Insurance Purchasing Program to serve as a health care purchasing pool for employers and would have made other changes to health care related provisions of several California Codes. It would have required employers to make health care expenditures or elect to pay an in-lieu fee to a specified fund. It would also have required employers to set up a cafeteria plan under IRC section 125. This bill was vetoed by Governor Schwarzenegger. The Governor stated: “AB 8 would put more pressure on an already broken system”. The Governor’s veto message is attached as Appendix 1.

SB 48 (Perata, 2007/2008) prior to the June 25, 2007 amendment would have established the California Health Care Coverage and Cost Control Act, which would have required every individual with income subject to the personal income tax to maintain a minimum policy of health care beginning January 1, 2011. The bill would also have permitted employers to elect to pay a fee in lieu of making health care expenditures and mandate certain employers adopt and maintain an IRC section 125 plan. The bill was held in the Assembly Appropriations Committee.

SB 820 (Ashburn, 2007/2008) is identical to SBX1 23. The bill would have established a credit against franchise and income tax in the amount of 15% of administrative costs associated with establishing or administering a “cafeteria plan.” The bill was held in the Senate Revenue and Taxation Committee.

## **FISCAL IMPACT**

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department’s costs are expected to be minor. The credit created by this bill would require a new form or worksheet to be developed to calculate the credit. As a result, this bill would impact the department’s printing, processing, and storage costs for tax returns, the costs of which could be absorbed by the department.

## ECONOMIC IMPACT

### Revenue Estimate

Based on data and assumptions discussed below, the PIT and Corporation Tax revenue impact from this bill would be as follows:

Estimated Revenue Impact of SBX1 23 Effective 1/1/07 with Enactment After 6/30/07 (\$ in Millions)		
2007-08	2008-09	2009-10
- \$5	- \$56	- \$63

This bill does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

### Revenue Discussion

The revenue impact of this bill depends on the amount of qualified cafeteria plan tax credits that would be applied to reduce employer tax liabilities.

The estimated average cost of establishing a qualified cafeteria plan is \$1,425, which is comprised of \$425 average fee paid to a third party plus \$1,000 internal administrative costs. Employers' costs associated with ongoing plan administration are estimated at \$40 per employee per year.

Based on California Employment Development Department reports it is estimated the average number of businesses during 2007 will be approximately 1.3 million. Data from various sources indicate the percentage of employers currently offering cafeteria plans that provide for the payment of employee health insurance premiums is approximately 30%. Therefore, it is project approximately 390 thousand businesses will offer qualifying section 125 plans to their employees during 2007. ( $1.3 \text{ million} \times 30\% = 390,000$ ) Using the same data sources, it is estimated approximately 357,000 businesses offered qualifying section 125 plans during 2006. New cafeteria plans offered by California employers would number approximately 33 thousand during 2007. ( $390,000 \text{ businesses offering plans during 2007} - 357,000 \text{ businesses offering plans during 2006} = 33,000 \text{ new cafeteria plans during 2007.}$ ) Using the estimated average cost of \$1,425, the cost to employers for establishing qualified cafeteria plans during 2007 is approximately \$47 million. ( $\$1,425 \times 33,000 \text{ new plans} = \$47 \text{ million.}$ )

Based on California Department of Finance reports, we estimate the average number of non-governmental California employees at approximately 12.8 million for 2007. Based on various data, it is estimated 50% of these employees have access to a cafeteria plan that provides for the payment of health insurance premiums and 60% of these employees participate in the plans. Using the estimated average cost of \$40 per participating employee, the estimated cost to employers for internal administrative costs during 2007 is approximately \$154 million. ( $12.8 \text{ million employees} \times 50\% \text{ with access to qualified cafeteria plans} \times 60\% \text{ participation rate} \times \$40 \text{ cost per participating employee} = \$154 \text{ million.}$ )

Additional costs to administer a qualified cafeteria plan may include fees charged by banks, investment companies, insurance companies, retirement plan administrators and other providers that may independently provide service to the qualified cafeteria plan. These additional costs are assumed to average approximately \$100 per qualified cafeteria plan. Additional qualifying costs are estimated at approximately \$39 million. (390,000 employers with qualified cafeteria plans x \$100 average miscellaneous fees per employer = \$39 million.)

Total available credits related to establishing and administering qualified cafeteria plans for California employees would be approximately \$36 million for 2007. (\$47 million to establish plan + \$154 million ongoing internal administrative costs + \$39 million miscellaneous costs = \$240 million qualifying costs. \$240 million x 15% = \$36 million.)

This bill would not limit the credit to costs incurred for California employees, nor would it apply an apportionment percentage to the credit. It is estimated approximately 25% of employees participating in qualified cafeteria plans work for apportioning corporations. Therefore, approximately \$9 million of the credit calculated above would be generated from costs associated with California employees who work for apportioning corporations. (\$36 million X 25% = \$9 million). Based on FTB statistics, the average apportionment factor tends to be about 10%. Assuming a 10% apportionment factor applied to payroll, these apportioning corporations should generate total credits of \$90 million (\$9 million credit for California employees divided by 10% apportionment.) This results in total available credits of \$117 million. (\$36 million – \$9 million + \$90 million = \$117 million)

Employers may currently deduct the costs of establishing and administering cafeteria plans. This bill would not allow deduction of any costs for which the credit is allowed. Since the average tax rate of 7.5% is 50% of the 15% credit percentage, the value of the credit, after taking into account the offsetting loss of deductions, is approximately 50% of the amount of the credit, or \$14 million, for credits of non-apportioning businesses. (\$36 million - \$9 million = \$27 million. \$27 million x 50% = \$14 million.) Since only 10% of qualifying costs of apportioning corporations would be apportioned to California, the value of the credit to apportioning corporations, after taking into account the offsetting loss of deductions, is approximately 95% of the amount of the credits, or \$86 million. (\$90 million x 95% = \$86 million.) The deduction offset is calculated as follows: \$90 million credits divided by 15% credit percentage = \$600 million qualifying costs. \$600 million qualifying costs x 10% apportionment factor = \$60 million. \$60 million qualifying costs apportioned to California x 7.5% average tax rate = \$4.5 million lost deductions. (\$90 million - \$4.5 million = \$85.5 million, which is rounded to \$86 million.)

Of credits generated, it is assumed 50% would be applied in the tax year generated and another 30% would be applied during the carryover period. Total revenue loss for tax year 2007 is estimated at approximately \$50 million. (\$14 million value of credits associated with non-apportioning businesses + \$86 million value of credits associated with apportioning corporations = \$100 million. \$100 million x 50% credits applied = \$50 million.)

It is assumed this bill would not increase the number of employers offering qualified cafeteria plans. We have also assumed that administrative fees actually paid by employees (through payroll deduction) would not qualify for the credit.

Estimates in the table above have been converted to fiscal year cash flows.

### **ARGUMENTS/POLICY CONCERNS**

The bill appears to require qualified taxpayers to have California employees, but does not limit eligible costs to those allocable to such employees. Therefore, employers could claim the credit for costs attributable to non-California employees, which may be inconsistent with the policy objective the author is trying to achieve.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SBX1 23  
As Introduced October 11, 2007

AMENDMENT 1

On page 2, lines 15 and 16, and on page 3, lines 22, and 23, strike out "state. "Employer" also includes" and insert:

state,



# APPENDIX 1

BILL NUMBER: AB 8  
VETOED            DATE: 10/12/2007

To the Members of the California State Assembly:

I am returning Assembly Bill 8 without my signature.

While I appreciate the Legislature's efforts to reform our broken health care system and applaud the hard work that has gone into AB 8, I cannot sign this bill. AB 8 would put more pressure on an already broken system.

AB 8 does not achieve coverage for all, a critical step needed to reduce health care costs for everyone. Comprehensive reform cannot leave Californians vulnerable to loss or denial of coverage when they need it most. Finally, to be sustainable, comprehensive reform cannot place the majority of the financial burden on any one segment of our economy. Unfortunately, AB 8 falls short on all three accounts.

California needs a financially sustainable health care reform plan that shares responsibility, covers all Californians and keeps our emergency rooms open and operating. I cannot support reform efforts that fall short of these goals and threaten to weaken our already broken system.

Sincerely,

Arnold Schwarzenegger